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STATE FOR NEA/ELA, NEA/RA AND EEB/IDF  
USAID FOR ANE/MEA MCLOUD AND DUNN  
TREASURY FOR MATHIASON AND CONNOLLY  
COMMERCE FOR 4520/ITA/ANESA/OBERG

E.O. 12958: N/A

TAGS: ECON EFIN EG

SUBJECT: INFLATION RISES AGAIN

REF: A. Cairo 0150 B. Cairo 0152

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Summary  
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**¶11.** (U) Inflation increased to 10.5% year-on-year (y-o-y) in January, up from 6.9% y-o-y in December. The Central Bank responded by raising interest rates 25 basis points (bp) on February 7, defying expectations that rates would remain unchanged in order not to slow economic growth. The Central Bank cited food inflation as the main concern prompting the hike. Food inflation caused large public demonstrations in January (ref A). On a visit to local markets, staple prices, excluding cooking oil, had not increased since our last visit (ref B), but vendors expected to raise prices in the coming week, as wholesale prices increased. Vendors also lamented a drop in sales of fruits and vegetables. Bakers complained about the black market for government subsidized flour, and buyers complained about long lines, short supplies, and smaller pieces of bread. Given the weak monetary transmission mechanisms in Egypt, some local economists believe the Central Bank should allow greater exchange rate fluctuation to control prices, rather than counting on interest rate hikes to do the job.

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Inflation surges in January  
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**¶12.** (U) Inflation rates surged in January according to a report released February 11 by the Central Agency for Public Mobilization and Statistics (CAPMAS), the GOE inflation monitoring agency. Overall inflation increased to 10.5% year-on-year (y-o-y) in January, up from 6.9% y-o-y in December. The month-on-month increase of nearly 4% from December to January is the largest since January 1995. Food inflation jumped to 13.5% y-o-y in urban areas in January, up from 8.8% y-o-y in December. In rural areas, food inflation increased to 18.9% y-o-y, up from 12.3% y-o-y in December.

According to the CAPMAS report, the main factor in the increase was high global food prices, though heating oil increases also contributed to the higher rate of inflation.

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Central Bank Raises Rates  
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**¶13.** (U) The Central Bank's Monetary Policy Committee raised interest rates at its February 7 meeting by 25 bp, from 8.75% (deposits) and 10.75% (lending) to 9.0% and 11.0% respectively. This is the first rate change since December 2006. The move surprised financial analysts, who believed the Central Bank would keep rates unchanged in order not to slow economic growth. Egypt's economy grew at an annualized rate of 8.1% in the fourth quarter of 2007, the highest

level since the early 1990s. In raising interest rates, the Central Bank cited food inflation as the major concern. Rising food prices spurred demonstrations in a number of Egyptian cities in January (ref A). For most analysts, including the IMF Resident Rep, the 25 bp increase is merely symbolic, as banks are unlikely to change their lending behavior due to higher Central Bank rates. However, Goldman Sachs is projecting more rate hikes later this year.

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At the Local Markets  
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**¶4.** (U) At Shoubra Al Kheima market, in one of Cairo's poorest neighborhoods, prices of staples such as rice, pasta and beans had not gone up since our last visit two weeks ago (ref B), but vendors told us they planned to raise prices next week, as wholesalers had just increased prices. Cooking oil, on the other hand, had increased from LE 7 (\$1.27) - LE 7.5 (\$1.36) two weeks ago to LE 8 (\$1.45) this week. At Al Tawfikia market in a lower middle class part of Cairo, vendors told us that buyers have stopped purchasing fruit and all but the most basic vegetables, complaining that prices are too high. A private bakery owner echoed stories we heard from Minister of Social Solidarity Ali Al Moselhi (ref B) about the black market for subsidized flour. Public bakeries buy 100 kilo bags of flour for LE 90 (\$16) from the government. While using part of the flour to produce low cost bread, they sell most of it on the black market for LE 110-120 (\$20-22)/bag (Note: This is lower than the price Al Moselhi quoted us, which was LE 210, or \$38).

**¶5.** (U) We visited a public bakery in Al Tawfikia, where approximately 35 people were waiting to buy bread in two lines segregated by gender. Buyers told us that the bakery allowed people to cut the line if they were willing to pay more than the official price of 5 piasters (\$.01)/piece of bread. Lamenting the long wait, buyers said the bakery often runs out of bread before everyone has a chance to buy. Once public bakeries close, buyers' only recourse is to purchase bread at private bakeries, where it averages 25 piasters (\$.05)/piece. Buyers also claimed that public bakeries were making pieces of bread smaller than normal, to stretch the small quantity of subsidized flour the bakeries retain after selling the rest on the black market. An newspaper article on February 13 claimed that the Ministry of Social Solidarity (MSS) would raise the price of subsidized bread to 10 piasters (\$.10)/piece in July, but would also require that each piece weigh 130 grams (Note: This may be a "trial balloon" by the MSS to gauge public reaction to reduction of bread subsidies).

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Comment  
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**¶6.** (U) The interest rate hike signals GOE awareness of public concern about high prices, and underlines the Central Bank's policy focus on fighting inflation. It also demonstrates how Egypt has weathered the financial problems facing other economies, which are reducing rates and promoting fiscal stimuli, despite the inflation-causing effects of those policies. Global prices are likely to remain high, and abundant liquidity in Egypt's banking sector has kept domestic credit growth strong. Local economists point out that to control inflation, the Central Bank would be better off allowing greater appreciation of the Egyptian pound against the U.S. dollar, to dampen high import prices. The Central Bank has carefully managed the exchange rate since late 2004, allowing only minor fluctuations in a narrow band between LE 5.45/\$1 and LE 5.6/\$1. Some economist predict the GOE, which is loath to allow the pound to appreciate, may try to control prices by imposing more trade-distorting export fees to increase domestic supply, as it did with rice (ref B).

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